EMPLOYING FAMILY MEMBERS: Lower your tax burden and help your family get ahead on retirement

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HIGHLIGHTS

01 The primary financial advantage of employing family members is that doing so will reduce your income taxes.

02 If your practice is unincorporated, the wages paid to children under age 18 are not subject to Social Security or Medicare tax.

When you focus on taxes and children, you likely think of personal exemptions or taking a child care credit or college-related tax credits. However, you can realize an even greater tax shelter opportunity through your children's low tax brackets. ▸▸

▸▸ **UNLIKE WHEN** children have "unearned income," which is subject to the "kiddie tax" (meaning their income is taxed at your bracket), earnings through employment are taxed in the child's bracket, which is almost always lower than yours.

If your child is in a zero or other low tax bracket, his or her wages will avoid most of the federal income taxes that they would incur if the compensation were paid to you. When you factor in the phase-out of itemized deductions and personal exemptions and payroll taxes, some physicians have marginal tax brackets higher than 50%. If you're in that position, you can avoid substantial taxes by adding your children to your payroll. That's because your practice can deduct the child's pay and avoid taxes on this money in your higher bracket.

Furthermore, if your practice is unincorporated, the wages paid to children under age 18 are not subject to Social Security or Medicare tax, which they would be if they were paid to you. The annual wages of the children up to $6,100 are completely sheltered from federal tax through the child's annual standard deduction. The tax savings for the family as a whole is compelling and

> THE ADVANTAGE OF EMPLOYING FAMILY MEMBERS IS THAT DOING SO WILL REDUCE YOUR INCOME TAXES, GIVE THEM A JOB, AND ALLOW THEM TO FUND ROTH IRAs, PROVIDING THEM A JUMP START ON RETIREMENT.

the children can build up money for retirement, college, or other purposes.

Your child could even participate in your practice's 401(k) plan if he or she meets the minimum age and service requirements. However, if you reduce these requirements so that they qualify, the lower requirements would also apply to the rest of your staff.

USE WAGES TO FUND RETIREMENT ACCOUNTS

The best use of the children's compensation is to make annual contributions to a Roth Individual Retirement Account (IRA), which has no minimum age limit for contributions. You can only contribute to a Roth if you have earned income of at least the contribution amount (up to the $5,500 annual limit). Using a traditional pre-tax IRA instead does not make sense because the tax deduction is irrelevant when the child is in a low or zero federal tax bracket. Whether the child is in a high tax bracket at the time of retirement is not important since the Roth IRA should not ever be subject to taxation on its growth so long as distributions occur after age 59-1/2.

If the child's wages are used to fund the Roth IRA, and it is fully funded throughout childhood, it is likely that the investments will grow and be worth millions 40 to 50 years later due to tax-free compounding.

Working with family: The Do's and the Don'ts

While having physicians' family members on the payroll can be a help to a medical practice, it can also present complications that may prove difficult to manage given the personal relationships and the dynamics of an employer-employee relationship.

Practice management consultant Judy Bee has some tips for physicians considering adding family to the staff.

1

Don't hire anyone you can't fire. Be explicit when bringing a family member on board that good performance is necessary to continue working for the practice.

2

Don't expect other staff members to provide adequate feedback on your family member's performance. The best thing to do is foster an open environment where every worker is treated equally.

3

If your spouse is the office manager—a common arrangement in many practices—he or she must set a shining example of a good employee. He or she must be held to the same performance standards that apply to any manager.

4

If the spouse-manager makes a decision, you should publicly support it. If you have questions, raise them in private. If there are too many decisions that are not consistent with your goals and values, then you may have the wrong manager.

5

Put the supervision of a family member in the hands of another staffer. Make it clear to your family member that you can't save him or her from termination if they don't perform well.

Unlike a traditional IRA, a Roth IRA does not compel distributions at age 70 1/2; there are no mandatory distributions to the account owner.

Furthermore, even if the child uses his or her earnings for purposes other than funding a Roth, the fact that the child has earned income would by itself permit you to contribute to the child's Roth IRA out of your own funds. Since a Roth IRA does not have to be funded directly out of the beneficiary's earned income. The funds will grow tax-free over many decades and you will help the child get a good start funding his or her future retirement. If the funds are needed for college, they could be withdrawn penalty-free from the Roth IRA, although the growth would then be subject to income taxes.

I opened our kids' IRA at Vanguard Mutual Fund Family using the Social Security numbers for my four children, listing myself as the guardian in the title. Each monthly statement is sent to my address and the children's names are on the accounts followed by the words "a minor."

I have noticed that as our children turn are reaching age 21, the statements continue to come to me. One of these days, I may get around to telling my children about their IRAs. In the interim, I continue to make all of the decisions regarding the investments of "their" money. An advantage of the children not knowing about this wealth is that such knowledge could stunt their initiative to someday begin contributing their own funds towards their retirements.

HOW TO PAY YOUR CHILDREN

Payments to the children for services to your practice should be made with irregular amounts and at irregular times and based upon a reasonable hourly wage for their services. If, instead, you write one check annually for $5,500 (to fund the Roth IRA the maximum amount), it will appear that they are not bona fide employees and you risk having your practice lose the tax deductibility of the payment of wages.

RESPONDING TO GOVERNMENT INQUIRIES

Some of my clients have had their grandchildren on their payrolls. In the case of very young children, sometimes a form letter will come from the Social Security Administration inquiring whether a mistake has been made because of the age of the employee. The government is focused on one person using another's Social Security number in case an illegal alien is using someone else's number. If you receive such an inquiry, you should respond by stating that the child or grandchild is your employee, rather than ignoring the inquiry.

The primary advantages of employing family members are that doing so reduces your income taxes, gives the child a job, and allows him or her to fund a Roth IRA for many years, providing the child with a head start on retirement plan funding and allowing them to enjoy many decades of tax-free compounding. The saved income taxes can also be used to fund a 529 Plan for their future college expenses and to help them build up a nest egg for their later years. ◘

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